Mutual of Omaha Insurance Company ■ Home Office: Mutual of Omaha Plaza / Omaha, Nebraska 68175 ■ (402) 342-7600 ■ V. J. Skutt, Chairman of the Board ■ J. D. Minton, President

Mutual of Omaha
People you can count on...

Address all correspondence to

WASHINGTON, DC, REGIONAL GROUP OFFICE
Suite 703
1919 Pennsylvania Ave. NW
Washington, DC 20006
Phone 785-1919

NORMAN C. CONWAY
Regional Manager

January 10, 1984

[redacted]

STAT

Administrator,
Government Employees
Health Association
P. O. Box 463
Washington, D.C. 20044

Re: Audit Report
No. E-83-006

Dear Lenda:

For your information I have enclosed a copy of our response to the captioned audit report.

Sincerely,

Norman C. Conway
Regional Manager

NCC:slr
Encl.

Affiliated Companies: United of Omaha ■ Omaha Indemnity ■ Companion Life Insurance Company ■ Omaha Financial Life Insurance Company ■ Tele-Trip Company ■ Constitution Insurance Company of Canada ■ Mutual of Omaha Fund Management Company, sponsor of Mutual of Omaha Funds

Mutual of Omaha Insurance Company ■ Home Office: Mutual of Omaha Plaza, Omaha, Nebraska 68175 ■ (402) 342-7600 ■ V. J. Skutt, Chairman of the Board ■ J. D. Minton, President

Mutual of Omaha

People you can count on...

December 30, 1983

Mr. Kevin J. Burns
Assistant Director
for Insurance Programs
U. S. Office of Personnel Management
Washington, DC 20415

Dear Mr. Burns:

Attached is Mutual of Omaha's response to the unresolved findings contained in Audit Report No. E-83-006 dated September 14, 1983, and received by Mutual on November 23, 1983.

Please contact us if you have questions or require additional information.

Sincerely,

R J Sampson

Richard J. Sampson
Executive Vice President

RJS/sle

Attachment

Mutual of Omaha Insurance Company
Response to Audit Report NO-E-83-006

Dated September 14, 1983

Responses to Audit Findings

A. Premium Taxes

Corrective Action Recommended

(a) Mutual objected to retroactive application of a weighted average tax rate for each plan for the years 1976-81 and OPM agreed that a prospective application of the weighted average tax rate would be the most appropriate and equitable resolution of the issue. This concept, however, was not applied by OPM in arriving at the $118,179 adjustment. Based on this agreement, the appropriate adjustment to Premium Taxes is to correct those calculations where an incorrect tax base was used. This results in an undercharge of $242,181 instead of the $118,179 overcharge indicated in the Corrective Acion Recommended. Calculation of the $242,181 is shown on Schedule I. The appropriate Corrective Action Recommended should require Mutual to charge FEP $242,181 plus excess investment income.

(b)&(c) Mutual has already corrected procedures in order to comply with recommended action.

B. Administrative Expenses

1. Programming Error

Corrective Action Recommended

(a) Mutual agrees to credit the respective plans for overcharges totalling $107,850.

(b)&(c) Mutual has already corrected procedures in order to comply with action recommended.

2. Return on Investment

The audit findings do not include Mutual's position that the cost of investment included in rent costs is an allowable expense since it is a portion of the normal cost of rent based on Mutual of Omaha's lease agreement with United of Omaha Life Insurance Company which was executed on November 20, 1956. In general, this agreement defines the costs which will be included in determining rent costs of both companies. These expenses are:

1. Maintenance and operational costs

2. Taxes and other assessments

3. Depreciation

4. An amount equal to 5% of the book value of land

5. An amount equal to 5% of the depreciated value of each property and/or improvement

The expenses are shared by the companies based upon an allocated percentage of occupied square footage. Each company in turn allocates these expenses to their various lines of business. The Group Operation is allocated a portion of this expense based upon their square footage occupied. The Group Operation in turn allocates their portion of this expense to all group policies including the FEHBP plans. This practice has been followed each year since execution of the 1956 lease agreement. Because of this practice, it is Mutual's opinion that Mutual comes within the "appropriate circumstances" referred to in the decision of the Armed Services Board of Contract Appeals in the appeal of Blue Cross and Blue Shield of Pennsylvania (ASBCA No. 21113, dated July 20, 1982). In order to avoid a subsidy of these contracts by Mutual's other lines of business and because of the absence of compensation for ROI through the risk charge or in any other fashion other than cost, it is Mutual's opinion that the $47,031 should be considered an actual cost and allowable as a contract cost.

Corrective Action Recommended

(a) It is Mutual's position that the $47,031 is an allowable cost and no adjustment in charges is required.

(b) Mutual agrees that properly computed charges for cost of capital are allowable contract charges.

Mutual recommends that the wording of the audit findings (Page 12) be changed to the following in order to more accurately state the findings.

A. Premium Taxes

The FEP was undercharged $242,181 for premium taxes during the years under review as a result of inconsistencies in computing tax bases. (See Schedule A for details.)

Our on-site review of Mutual's methodology for developing the tax base disclosed numerous adjustments which were explained as necessary to arrive at "earned premiums" (part of input to the Premium Tax formula). Since we were not satisfied with Mutual's explanation for the development of the "earned premiums", we recommended an alternative method of developing the tax base used by certain other FEP carriers.

In responding to our draft audit report, Mutual clarified its explanation of "earned premiums" by defining the concept in terms of clear-cut formula, and by acknowledging that the formula had been misapplied in some years. Mutual pointed out that, "Over the life of the contract, both methods should eventually result in the same tax charges." Mutual also correctly stated that, "To retroactively require Mutual to change its tax base for years 1976 through 1981 would not only result in inequities, but would also produce erroneous results." Consequently, we withdraw our recommendation that Mutual use the alternate method recommended and we accept Mutual's revised computation of premium taxes. Accordingly, $242,181, resulting from inconsistencies made in computing the tax base, is questioned.

We continue to recommend, however, that Mutual use a weighted average tax rate for each plan. Mutual is agreeable to changing to a weighted average tax base on a prospective basis, but objected to retoractive application of such rates to the years 1976-81. We agree that a prospective application of the weighted average tax rate would be the most appropriate and equitable resolution of the issue.

Mutual also recommends that the wording of the audit findings (B.1 Programming Error (page 13), be changed to the following in order to more accurately state the findings.

B. Administrative Expenses

1. Programming Error

Mutual allocates Home Office Group Division expenses to FEP by means of a highly complex computer program. In the course of reviewing machine-generated expenses, allocated to FEP, we found a number of instances where FEP was charged with more than 100% of expenses incurred in a department. Further investigation disclosed that this resulted from a programming defect which called for seven-digit numbers to by inputed into a six-digit data field. This defect resulted in truncation of the first digit numbers, which in turn resulted in distortion of machine-generated ratios.

Between 1978 and 1981, the FEP was overcharged $52,468 as a result of truncation errors affecting the machine-generated Group Division expenses. In addition, FEP was overcharged

$55,382 for salaries and overhead expenses which were computed by applying a load factor to machine-generated Group Division expenses.

Mutual concurs with this finding.

TRANSMITTAL SLIP	DATE
TO: C/BSD	
ROOM NO.	BUILDING

REMARKS:

Bill -

Before I ask any dumb questions of anyone, do you understand this? Even after reading it I am not sure who has done what to whom - it's like a stream of consciousness novel. Please advise.

FROM:		
ROOM NO.	BUILDING	EXTENSION

FORM NO. 241 1 FEB 55 REPLACES FORM 36-8 WHICH MAY BE USED. (47)

STAT

ROUTING AND TRANSMITTAL SLIP

Date NOV 29 1983

TO: (Name, office symbol, room number, building, Agency/Post)	Initials	Date
1. DD/Pers/SP	MW	11/30
2. ~~EO/OP~~ DEC 1 1983		
3. DD/Pers DEC 1 1983		
4.		
5. C/BSD		

	Action		File		Note and Return
	Approval		For Clearance		Per Conversation
	As Requested		For Correction		Prepare Reply
	Circulate		For Your Information		See Me
	Comment		Investigate		Signature
	Coordination		Justify		

D/Pers 83-5523

REMARKS

Hank,

Attached is a letter for your signature acknowledging receipt of a copy of the OPM audit report on Mutual of Omaha's ABP operations for 1976 through 1981.

You should also know that their is a similar OPM audit not yet fully resolved on the local [redacted] for the same period. I would like to brief you on it sometime.

STAT

P/S PD

[redacted]

STAT

DO NOT use this form as a RECORD of approvals, concurrences, disposals, clearances, and similar actions

FROM: (Name, org. symbol, Agency/Post)	Room No.—Bldg.
[redacted] C/BSD	5E 56
	Phone No. [redacted]

STAT

STAT

5041-102

OPTIONAL FORM 41 (Rev. 7-76)
Prescribed by GSA
FPMR (41 CFR) 101-11.206

☆ GPO : 1983 O - 381-529 (301)

Government Employees
• Health Association •

Post Office Box 463
Washington, D.C. 20044

Office of the
President

DEC 1 1983

Mr. Kevin J. Burns
Assistant Director for Insurance
Programs Compensation
Office of Personnel Management
1717 H Street, N.W., Room 809
Washington, D.C. 20006

Dear Mr. Burns:

Receipt is hereby acknowledged of your November 15, 1983 letter including Audit Report E-83-006-EXD of September 14, 1983. If you require our assistance in resolving the outstanding issues prior to the March 13, 1984 deadline, please let me know.

Sincerely,

STAT

Original to C/IB for mailing to Burns, 12/2/83
Copy for C/IB

United States
**Office of
Personnel Management**

Washington, D.C. 20415

In Reply Refer To: CN

Your Reference:

NOV 15 1983

STAT

[redacted]
Government Employees Health Association
P.O. Box 463
Washington, DC 20044

STAT

Dear [redacted]

Enclosed are four copies of the Office of Personnel Management's audit report No. E-83-006, Ex. D, dated September 14, 1983. This audit was conducted by representatives of the Office of the Inspector General. They examined the Federal Employees Program underwriting operations at the Mutual of Omaha Insurance Company for the years 1976 through 1981. The audit was conducted pursuant to 5 U.S.C. Chapter 89; 5 CFR Chapter 1, Part 890; and your Federal Employees Health Benefits contract.

I would appreciate an acknowledgement of your receipt of this report within 10 days.

This audit was one of seven companion audits which examined Mutual of Omaha's underwriting activities as related to the plans it underwrites in the Federal Employees Health Benefits Program. Separate audit reports detailing findings relative to those plans are being concurrently sent to them.

Public Law 96-304 requires us to resolve all outstanding findings within six months of the date the audit is issued, or March 13, 1984 in this instance. Because of the similarity of issues and the one common subcontractor, we have been in direct discussions on these findings with representatives of Mutual of Omaha. We are therefore not requiring your plan's involvement at this time. In the event we require your assistance in the resolution of these findings we will contact you. In any case we will inform you immediately when all findings are resolved.

Sincerely,

Kevin J. Burns

Kevin J. Burns
Assistant Director
for Insurance Programs

Enclosures (4)

CON 114-24-3
January 1980

AUDIT REPORT

Federal Employees Health Benefits Program
Mutual of Omaha Insurance Company
Omaha, Nebraska

Underwriter for Employee Organization Plan:

Government Employees Health Association, Inc.
Association Benefit Plan
Plan 42, Contract CS 1065

Report No E-83-006-Ex D Date SEP 14 1983

Joseph W. Lowell, Jr.
Inspector General

CONTENTS

I. INTRODUCTION

In July 1982, we completed an audit of the Federal Employees Program (FEP) underwriting operations at the Mutual of Omaha Insurance Company (Mutual) for the years 1976 through 1981. The audit was conducted pursuant to the OPM contracts cited below; 5 U.S.C. Ch. 89; and 5 CFR Ch. 1, Part 890. Mutual serves as Underwriter for the following Employee Organization Plans:

Plan	OPM Contract No.	Mutual Policy No.
1. AFGE Health Benefit Plan	CS 1061	GMG - 4800
2. Rural Carrier Benefit Plan	CS 1073	GMG - 1846
3. Foreign Service Benefit Plan	CS 1062	GMG - 1798
4. Association Benefit Plan	CS 1065	GMG - 1799
5. Panama Canal Area Benefit Plan	CS 1066	GMG - D184
6. Alliance Health Benefit Plan	CS 1164	GMG - 4291
7. Postal Supervisors Health Benefit Plan	CS 1875	GMG - DD90

The purpose of our audit was to review FEP underwriting costs and activities at Mutual`s Home Office in Omaha, Nebraska, and those costs allocated to FEP from Mutual`s Washington, D.C. Regional Office. Claims processing functions performed by Mutual at its Group Claim Office in Rockville, Maryland (for Plans 46, YV) and in Panama (for Plan 43) were not audited at this time. However, our report E-82-004, dated March 10, 1982, covers the operations of the Group Claim Office in Rockville. Claims for the other plans underwritten by Mutual are administered [redacted] in Washington, D.C. STAT (Plans 30, 40, and 42) and by the Tolley International Corporation in Washington, DC. (Plan 38). Audits of these entities are detailed in our audit reports E-83-001 and E-81-003, respectively.

The objectives of our audit were to determine whether costs charged to the FEP and services provided to FEP subscribers were in accordance with terms of the Contracts. We also sought to determine whether Mutual`s practices and procedures resulted in efficient, effective and economical operations.

Our last audit of operations at Mutual covered the functions of the Underwriter for the years 1974 and 1975 in the following reports:

Plan	Report No.	Date of Report
1. Panama Canal Area Benefit Plan,	E-80-002	July 2, 1980
2. AFGE Health Benefit Plan,	E-80-003	August 1, 1980
3. Association Benefit Plan,	E-80-005	September 5, 1980
4. Foreign Service Benefit Plan,	E-80-006	September 8, 1980
5. Alliance Health Benefit Plan,	E-80-007	September 5, 1980
6. Rural Carrier Benefit Plan.	E-81-003	January 26, 1981

All findings from the above reports relating to the Underwriter have been resolved.

The results of our on-site review were provided to Mutual by written Informal Audit Inquiries and were discussed with Mutual`s officials at an exit conference. All audit findings in this report were provided to Mutual of Omaha in our Draft Report E-83-001D, dated October 21,1982. Plan`s comments to the Draft Report, dated January 11, 1983, were considered in the preparation of this report and are included as Appendix A of this report.

II. SCOPE OF AUDIT

The audit was performed in accordance with generally accepted Government auditing standards and included such tests of the accounting records and such other auditing procedures as were considered necessary in the circumstances.

We examined applicable elements of income and costs reported in the FEP Annual Accounting Statements, pertaining to Mutual in its capacity as Underwriter for the Employee Organization Plans, covering the years 1980 and 1981 in the case of the Postal Supervisors Health Plan, and the years 1976 through 1981 for all other Plans.

We reviewed the propriety and accuracy of subscription income, health benefits charges, administrative expenses, premium taxes and investment income attributable to Mutual. We used the cost principles prescribed by 41 CFR, Part 1-15 as guides in the determination of allowability, allocability and reasonableness of administrative expenses.

III. FINANCIAL DATA

SCHEDULE D

ANNUAL ACCOUNTING STATEMENT SUMMARY

ASSOCIATION BENEFIT PLAN

Year Charged in Annual Accounting Statement

	1976	1977	1978	1979	1980	1981
1. SUBSCRIPTION INCOME	$11,678,751	$11,511,310	$11,580,680	$16,576,332	$16,415,118	$17,797,681
2. HEALTH BENEFIT CHARGES	$10,444,603	$11,508,198	$12,915,824	$13,026,260	$15,318,950	$18,135,030
3. EXPENSES AND RETENTIONS						
a. Administrative Expenses						
(1) Organization	$298,969	$294,783	$287,517	$ 414,408	$ 410,378	$ 444,942
(2) Administrator						
(3) Underwriter	121,404	176,636	285,207	390,536	459,219	576,997
b. Premium Taxes	239,241	264,409	291,488	310,198	356,489	422,760
c. Service Charge	69,300	69,300	69,300	69,300	69,300	81,500
Total	$728,914	$805,128	$933,512	$1,184,442	$1,295,386	$1,526,199
4. SPECIAL RESERVE						
a. Gain (loss) on Current Subscriptions	$ 505,234	$ (802,016)	$(2,268,656)	$2,365,630	$ (199,218)	$(1,863,548)
b. Investment Income	207,362	292,013	178,028	177,589	301,746	280,742
c. Adjustments						
d. Special Reserve - Beginning	1,577,640	2,290,236	1,780,233	(310,395)	2,232,824	2,335,352
e. Special Reserve - Ending	$2,290,236	$1,780,233	$ (310,395)	$2,232,824	$2,335,352	$ 752,546

IV. SUMMARY OF FINDINGS

The results of our audit are summarized below and are detailed in Section V.

	Amount Questioned	Underwriter Agrees	Underwriter Disagrees
A. Premium Taxes			
Premium taxes charged to FEP were not properly computed.	$118,179	$118,179	
B. Administrative Expenses			
Administrative expenses charged to FEP for the Plans and years reviewed are questioned as follows:			
1. Programming Error	107,850	107,850	
2. Return on Investment	47,031		$47,031
Total Questioned Costs	$273,060	$226,029	$47,031

V. AUDIT FINDINGS

A. Premium Taxes $118,179

The FEP was overcharged $118,179 for premium taxes during the years under review as a result of errors in computing tax bases and tax rates. As indicated in the attached Schedule A, premium taxes for 27 out of 38 plan-years were incorrectly computed in developing the tax base (21 plan-years), and in the use of erroneous tax rates (16 plan-years).

Our on-site review of Mutual`s methodology for developing the tax base disclosed that numerous adjustments, many of which appeared to us to be irrelevant and inconsistent, were explained as legitimate adjustments necessary to arrive at "earned premiums" (part of input to the Premium Tax formula). Since we were not satisfied with Mutual`s explanation for the development of the "earned premiums", we recommended an alternative method of developing the tax base, used by certain other FEP carriers.

In responding to our draft audit report, Mutual clarified its explanation of "earned premiums" by defining the concept in terms of a clear-cut formula, and by acknowledging that the formula was misapplied in many instances. Mutual pointed out that, "Over the life of the contract, both methods should eventually result in the same tax charges." Mutual also correctly stated that, "To retroactively require Mutual to change its tax base for years 1976 through 1981 would not only result in inequities, but would also produce erroneous results." Consequently, we withdraw our recommendation that Mutual use the alternate method recommended and we accept Mutual`s revised computation of premium taxes. Accordingly, $118,179, resulting from errors made in computing the tax base and the use of erroneous tax rates, is questioned.

We continue to recommend, however, that Mutual use a weighted average tax rate for each plan. Mutual is agreeable to changing to a weighted average tax base on a prospective basis, but objected to retroactive application of such rates to the years 1976-81. We agree that a prospective application of the weighted average tax rate would be the most appropriate and equitable resolution of the issue.

Corrective Action Recommended:

a. We recommend that the Contracting Officer require Mutual, in order to correct overcharges to FEP for the years 1976 through 1981, credit FEP $118,179, plus lost FEP investment income.

b. We recommend that the Contracting Officer require Mutual to properly compute and adequately explain the tax base used to compute premium taxes in future years.

c. We recommend that the Contracting Officer require Mutual to use separate weighted average tax rates for each Plan in computing premium taxes in future years.

B. Administrative Expenses

1. Programming Error $107,850

Between 1978 and 1981, the FEP was overcharged $52,468 as a result of 37 truncation errors affecting the machine-generated Group Division expenses. In addition, FEP was overcharged $55,382 for officers' salaries and overhead expenses which were computed by applying a load factor to machine-generated Group Division expenses.

Mutual allocates Home Office Group Division expenses to FEP by means of a highly complex computer program. In the course of reviewing machine-generated expenses allocated to FEP, we found a number of instances where FEP was charged with more than 100 percent of expenses incurred in a department. Further investigation disclosed that these (and other) errors resulted from a programming defect which called for seven digit numbers to be inputed into a six-digit data field. This defect resulted in truncation of the first digit numbers; which in turn resulted in distortion of machine-generated ratios.

Mutual concurs with this finding.

Corrective Action Recommended:

a. We recommend that the Contracting Officer require Mutual to credit the respective Plans for overcharges totaling $107,850 resulting from the above described programming defect.

b. We recommend that the Contracting Officer require Mutual to take the necessary steps to correct the programming defect in order to preclude reoccurence of similar overcharges in the future.

2. Return on Investment $47,031

FEP was charged $47,031 in 1976 through 1981 for the imputed cost of capital employed in facilities (land and buildings located in Omaha) used in performance of the Contracts. These charges were included in the rent charged by an affiliate to Mutual (United of Omaha), pursuant to a lease agreement between Mutual and United.

All of the prime contracts (between OPM and the Carriers) provide that only actual costs may be charged to FEP; therefore, an imputed cost is not allowable (Art. III, Sec. 3.5). Moreover, prior to January 1, 1982, charges of this nature were prohibited by the Federal Procurement Regulations (41 CFR 1-15.205-17,34(g)).

Not included in the above questioned costs is an estimate of the investment income that would have been earned if the funds disbursed for the improper charges had remained in FEP's Special Reserve and had consequently been invested. We believe, however, that lost investment income resulting from these improper charges should be a consideration in the settlement of this issue.

Corrective Action Recommended:

a. We recommend that the Contracting Officer require Mutual to credit FEP $47,031 plus lost investment income for Cost of Capital charges made through 1981.

b. Commencing with the contract year 1982, properly computed charges for Cost of Capital are allowable contract charges.

VI. ACCOUNTING STATEMENT ADJUSTMENTS

SCHEDULE D

QUESTIONED CHARGES

ASSOCIATION BENEFIT PLAN

	Year Charged Annual Accounting Statement						
AUDIT FINDING	1976	1977	1978	1979	1980	1981	Total
A. Premium Taxes	$21,750	$24,038	$26,500	$28,064	$32,410	$38,434	$171,196
B. Administrative Expenses							
1. Programming Error	-0-	-0-	$(142)	$(101)	$4,360	$450	$4,567
2. Return on Investment	$139	$203	268	350	488	474	1,922
Total Administrative Expenses	$139	$203	$126	$ 249	$4,848	$924	$6,489
Total	$21,889	$24,241	$26,626	$28,313	$37,258	$39,358	$177,685

Adjustments are required for the amounts shown above on the next Annual Accounting Statement.

Additional adjustments are required for lost investment income on all findings computed to date the funds are returned to FEP.

Mutual of Omaha Insurance Company ■ Home Office: ...al of Omaha Plaza, Omaha, Nebraska 68175 ■ (402) 342-7600 ■ ... Skutt, Chairman of the Board ■ J. D. Minton, President

Mutual of Omaha

People you can count on...

APPENDIX A

January 11, 1983

Mr. Joseph W. Lowell, Jr.
Inspector General
United States Office of
Personnel Management
1900 E Street, NW
Room 7353
Washington, DC 20415

Dear Mr. Lowell:

Attached is Mutual of Omaha's response to Draft Audit Report No. E-82-007-D received by Mutual on November 2, 1982. Please contact us if you have questions or require additional information.

Sincerely,

Richard J. Sampson
Richard J. Sampson
Executive Vice President

RJS/sle

Encs.

AUDIT FINDINGS COMMENT

A. Premium Taxes
   a. Do not concur
   b. Concur in part

The FEP has not been overcharged $590,508 for premium taxes during the years under review. The premium taxes allocated to the FEP were based on appropriate tax bases and rates in accordance with generally accepted accounting principles as applied in the insurance industry (41 CFR Section 1-15.205-44). The rationale and methods for computing premium taxes has been explained to auditors on several occasions. Thus, a change in the method of accounting for the premium taxes would effectively operate retroactively and violate sound government contract cost accounting principles requiring that changes in method of accounting be prospective only. Particularly is this true, when there are no unusual circumstances in the contractor's operations that would establish inequity in its treatment of premium taxes. Under Section 3.5 of the contracts "Expenses and Other Charges", actual taxes paid are recoverable and this is all Mutual has done.

The Employee Organization Plans underwritten by Mutual of Omaha are "Experience Rated Contracts". As such these are subject to the Procurement Regulations pertaining to experience rated contracts. See Exhibit I. The suggested correct tax base for computing premium taxes allocable to the FEP, as outlined in the audit findings, is not consistent with these regulations nor is it consistent with the tax base used by Mutual as a matter of insurance accounting practice employed in calculating premium taxes due the various states. The approach used by Mutual of Omaha is consistent with these regulations.

Under the "Experience Rated Contracts" concept Mutual records on its books as subscription income, the net amount earned by Mutual. The net amount earned by Mutual is equal to Mutual's share of subscription income from line 1C of the annual accounting statement plus any net transfers of accrued excess expense allowances to Mutual from the Organizations and/or Administrators, plus or minus any experience rated transfer to or from the Special Reserve. The amount of premium tax liability owed to the various states is also based on the net subscription income earned by Mutual and recorded by Mutual. The method followed by Mutual thus properly matches revenue and expense which is a basic accounting principle and properly reflects the premium tax liability that is due the various states. State Insurance Department regulations, pertaining to experience rated contracts, treat gains on subscriptions as a reduction in earned subscriptions and losses on subscriptions as an increase in earned subscriptions (to the extent recoverable in that year) for determining the tax base for that year's calculation of accrued taxes. Deficits carried forward are added to earned subscriptions in the year they are recoverable. A simple depiction of this approach is shown below.

Mutual's share gross subscription income	$10,000,000
Net transfer from organization	100,000
Experience rated transfer to special reserve	(500,000)
Earned subscription income (tax base)	$ 9,600,000

In the sample shown above the method proposed by the draft audit report would actually result in an overcharge of premium taxes for the year as the base would be $10,000,000. Conversely, in years when funds were transferred out of the Special Reserve, the method proposed by the draft audit report would result in an undercharge of premium taxes. Over the life of the contract both methods should eventually result in the same tax charges.

The method used by Mutual to determine the tax base has been used since 1962 when the first Employee Organization Plans were underwritten by Mutual. It has been consistent each year since then and was accepted in all past audits. Therefore, if a change in its method is required, it must be applied prospectively and not retroactively.

To retroactively require Mutual to change that tax base for years 1976 through 1981 would not only result in inequities, but would also produce erroneous results. If the tax base method were to be changed, it would be necessary to go back to the inception of the plans and adjust each year.

This, of course, is not practical or desirable since the differences in the tax base methods are primarily timing. Additionally, to deviate from this formula, for charging taxes to the Employee Organization Plans, as suggested in the audit findings, would result in overcharges of Premium Taxes should any of the plans cancel with a positive balance in the Special Reserve at the time of cancellation; i.e. Mutual would have correctly not paid taxes on that portion of the Subscription Charges transferred to the Special Reserve.

In reviewing the audit findings, Mutual concluded that the method of displaying the accrued tax calculation, in the annual accounting statement, could be improved. With the exception of items, shown as "Changes Required", the attached tax summaries reflect an improved way of displaying the accrued tax calculations and also shows that the method of applications has been consistent between plans and between years. This is the method used by Mutual in paying taxes and the method outlined in the Procurement Regulations. Mutual will use this method to show accrued tax calculations on all future accounting statements. The "changes required" represents items discovered during our review that were improperly handled. The attached schedule reflects the adjusted premium taxes amount incurred by Mutual for each year 1976 through 1981 and the difference between the adjusted tax and the tax included on the accounting statements.

Regarding the tax rate used, Mutual was using an across-the-board weighted average tax rate for all Plans (except the Panama Canal Area Benefit Plan) of 2.2%. This average tax rate was used because a yearly weighted average tax rate for each Plan is very time consuming to develop and does not produce significantly different results. The attached tax summaries show that, with the exception of the Foreign Service Benefit Plan and the Association Benefit Plan, there was very little, if any, difference between the average tax rate used and the weighted average tax rate. Further, this average tax rate approach has been consistently used between plans and between years and was accepted in all past audits. For these reasons, Mutual feels it is improper as well as inequitable to switch to a weighted average rate for each Plan on a retroactive basis.

Mutual does concur that the rates used for American Foreign Service and the Association Benefit Plans should be different than the average. The effect of the revised rates has also been incorporated on the attached schedules.

Conclusion

It is Mutual's opinion that the appropriate tax base was used and should continue to be used for the following reasons:

1. Plans underwritten by Mutual are on an experience rated basis.
2. The tax base used is in accordance with OPM Procurement Regulations pertaining to experience rated contracts.

3. The tax base used is in accordance with State regulations and is used in calculating actual taxes incurred. It reflects accrued taxes that appear on Mutual's Annual Statement Blanks.
4. The tax base used was consistent between plans and between years.
5. The tax base used was accepted and approved in all prior audits.
6. Use of any other base would result in overcharges or undercharges to each plan.
7. There are no unusual circumstances in Mutual's operations dictating a retroactive change in tax accounting.

Also it is Mutual's opinion that the average tax rate used for the years 1976 through 1981 should be accepted for the following reasons:

1. Very little, if any, difference results between the tax rate used and the weighted average tax rates (except for Foreign Service Benefit Plan and the Association Benefit Plan).
2. Average tax rate used has been consistent between the plans and between years.
3. Use of an average tax rate was approved in all past audits.
4. The computations method result only in a return of premium taxes paid to authorized authorities.

Mutual agrees to change the format and contents of the Accrued Taxes schedule on future accounting statements to more clearly show the tax base and tax calculation. Mutual is also agreeable to using a weighted average tax rate for each Plan on a prospective basis.

Mutual does not agree, however, to any retroactive adjustments based on tax base calculations or rate calculations that have been previously accepted and approved by OPM. This approach would result in inequities to both the Plans and Mutual.

Administrative Expenses

1. Programming Error

a. and b. concur in findings

Mutual has taken steps to correct the programming defect reflected on the audit. Mutual does request, however, that the word "significant" be deleted from the first sentence of the first paragraph under section B.1. The $107,850 overcharge resulting from the defect is in no way significant when compared to total expenses incurred for the periods in question.

2. Return on Investment

a. and b. Do not concur

It is Mutual's position that the cost of investment included in rent costs is an allowable expense since it is a portion of the normal cost of rent based on a lease agreement. Mutual has a lease agreement with United

Benefit Life Insurance Company which was executed November 20, 1956. In general, this agreement defines the costs which will be included in determining rent costs of both companies. These expenses are:

1. Maintenance and operational costs.
2. Taxes and other assessments.
3. Depreciation.
4. An amount equal to 5% of the book value of land.
5. An amount equal to 5% of the depreciated value of each property addition and/or improvement.

The expenses are shared by the companies based upon an allocated percentage of occupied square footage and accord with 41 CFR 1-15.205-34g. It is Mutual's position that cost of investment should not be classified as a separate expense subject to adjustment.

Mutual believes that the conclusions in the draft audit report are inequitable because Mutual paid rent to United, and United is entitled to a fair return on its investment in the same manner as any landlord. Moreover, the rent charge is extremely reasonable when compared to rent costs in the Omaha area. In addition, Mutual should be allowed cost of investment on capital employed in facilities since the cost has been consistently allocated to the contract over its life, was not included in any overall profit factor and was accepted in previous audits. Additionally, the facilities cost of capital as a recoverable cost was recognized as an imputable cost under OFPP Policy letter 80-7 (45 FR 82594, December 15, 1980.)

A recent decision of the Armed Services Board of Contract Appeals, in the Appeal of Blue Cross and Blue Shield of Pennsylvania, ASBCA No. 21113 dated July 20, 1982, squarely establishes that Return on Investment is an allowable cost or expense in "appropriate circumstances." Mutual's costs in this respect are equitable and reasonable and it is our opinion that Mutual comes within the "appropriate circumstances" referred to in the decision. The decision concluded that the term "administrative expense incurred", as used in the contract the Board had under consideration, (language identical to the contracts audited here) embraced return on investment. Just as was true in the PBC-BS case, the traditional Government contract policy and practice of reimbursing ROI through profit rather than as a cost was not deemed to be, and was not understood by the parties to be, applicable to Mutual's contracts. The risk charge did not and was not intended to cover ROI or to function as a normal profit factor which would be presumed to cover ROI; that given a primary goal of the parties to avoid a subsidy of these contracts by Mutual's other lines of business and the absence of compensation for ROI through the risk charge or in any other fashion other than as a cost, our contracts must also be interpreted as allowing ROI as a cost.

The $47,031 charged by Mutual in 1976 through 1981 was not included nor was it intended to be included as compensation in the risk charge applicable to these contracts and should therefore be considered an actual cost and allowable as a contract cost.

OPMAR 16-4

The following are exerpts from the Office of Personnel Management Procurement Regulations dated October 20, 1981:

Subpart 16-4.152-1 (51577)

(b) Experience rated contract

1. In an experience rated contract, the subscription charge per subscriber is fixed at the beginning of the contract term, but is subject to redetermination based upon actual cost incurred.
2. If upon redetermination there is a surplus of the subscription charges collected by the carrier over the cost of providing the benefits, the surplus is carried forward to the next contract term as a positive balance in an account called the "special reserve". Conversely, if the cost of providing the benefits exceeds the subscription charges collected, the deficit is carried forward to the next contract term as a negative special reserve balance.

Subpart 16-4.151-7 (51577)

"Experience rate means a rate for a given group which is the product of that group's actual paid claims, administrative expenses, retentions, and estimated claims incurred but not reported, adjusted for benefit modifications, utilization trends, and trends in the economy."

Exhibit I

Subpart 16-3.808-50 (51574)

(b) "Under FEHBP experience rated contracts, administrative expenses are determined on the basis of actual costs incurred."

Subpart 16-4.153 (51578)

(b) "Administrative expenses. Administrative expenses consist of all allocable, allowable and reasonable expenses incurred in the adjudication of subscriber benefit claims or incurred in the carrier's overall operation of the business. Unless otherwise stated in the contract, administrative expenses include, in part, all taxes including premium taxes."

Association Benefit Plan

Premium Taxes

GMG-1799

	1976	1977	1978	1979	1980	1981	Total
1. Subscription Income (Underwriters Portion Only)							
(a) Semi-monthly	$11,073,225	$11,256,942	$11,300,837	$13,991,896	$15,078,490	$16,865,239	$
Contingency Reserve	45,064	0	0	1,682,527	731,250	487,500	
(b) Beginning Unpaid	(1,237,095)	(1,505,589)	(1,472,174)	(1,462,500)	(1,950,000)	(2,145,000)	
Ending Unpaid	1,505,589	1,472,174	1,462,500	1,950,000	2,145,000	2,145,000	
(c) Total	$11,386,783	$11,223,527	$11,291,163	16,161,923	$16,004,740	$17,352,739	$
Subscription Income Transferred to Special Reserve	(505,234)	0	0	(2,062,063)	0	0	
Special Reserve Transferred to Subscription Income	0	802,016	1,958,261	0	199,218	1,863,548	
Transfer Due Underwriter-Excess Allowance	(7,000)	(7,000)	0	0	0	0	
(1) Premium Tax Base Used-Annual Accounting Statement	$10,874,549	$12,018,543	$13,249,424	$14,099,860	$16,203,958	$19,216,287	$
(2) Tax Rate Used	.022	.022	.022	.022	.022	.022	
(3) Taxes Charged on Annual Accounting Statement	$ 239,241	$ 264,409	$ 291,488	$ 310,198	$ 356,489	$ 422,760	$
(4) Corrections Required to Adjust Tax Base to Base Used in Paying Taxes							
Subscription Income Transferred to Special Reserve	$ 0	$ 0	$ 0	$ 6,828	$ 0	$ 0	$
Special Reserve Transferred to Subscription Income	0	0	0	0	0	0	
Transfer Due Underwriter-Excess Allowance	0	0	0	0	0	0	
(5) Premium Tax Base on Which Mutual Paid Taxes (Lines 1 & 4)	$10,874,549	$12.018,543	$13,249,424	$14,106,688	$16,203,958	$19,216,287	$
(6) Plan Weighted Average Tax Rate-Paid Taxes	.020	.020	.020	.020	.020	.020	
(7) Taxes Accrued	$ 217,491	$ 240,371	$ 264,988	$ 282,134	$ 324,079	$ 384,326	$
(8) Difference (Lines 3-7)	$ 21,750	$ 24,038	$ 26,500	$ 28,064	$ 32,410	$ 38,434	$171,1